

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
LEONARD HABER	:	
for Redetermination of a Deficiency or for	:	
Refund of New York State Personal Income Tax	:	
under Article 22 of the Tax Law for the Years	:	
1985 and 1986.	:	

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	:	DETERMINATION
	:	DTA NOS. 810076
	:	AND 810077

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In the Matter of the Petition	:
of	:
LEONARD AND MARINA HABER	:
for Redetermination of a Deficiency or for	:
Refund of New York State Personal Income Tax	:
under Article 22 of the Tax Law for the Year	:
1987.	:

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Petitioners, Leonard and Marina Haber, c/o Peter Newman, 700 Veterans Memorial Highway, Hauppauge, New York 11788, filed petitions for redetermination of deficiencies or for refund of New York State personal income tax under Article 22 of the Tax Law for the years 1985 through 1987.

A hearing was commenced before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on July 16, 1993 at 9:15 A.M., continued at the same offices on September 14, 1993 at 9:15 A.M., and concluded on December 7, 1993 at 11:00 A.M., with all briefs to be filed by March 21, 1994. Petitioners filed briefs on February 8, 1994 and March 21, 1994. The Division of Taxation filed a brief on February 28, 1994. Petitioners appeared by Peter R. Newman, Esq. The Division of Taxation appeared by William F. Collins, Esq. (David C. Gannon, Esq., of counsel).

ISSUES

I. Whether the Notice of Deficiency issued to Leonard and Marina Haber was properly

mailed.

II. Whether it was proper for the Division of Taxation to disallow certain corporate expenses as unsubstantiated and to, in turn, consider the additional corporate income, arising from the disallowed expenses, as additional unreported income of petitioners.

#### FINDINGS OF FACT

Petitioner Leonard Haber was the sole shareholder and president of a corporation known as Criticare Support Services, Inc. ("Criticare"). Criticare was in the business of supplying nurses to hospitals on a temporary basis. The hospitals paid Criticare for the nursing services and Criticare, in turn, provided remuneration to the nurses.

Mr. Haber filed a New York State Resident Income Tax Return for the year 1985 wherein he reported wages of \$66,950.00. Mr. Haber's address was listed as 1438 3rd Avenue, New York, New York 10028. The amount of wages reported on the return corresponded with the total of the three wage and tax statements from Criticare which were attached to the return. Mr. Haber also reported interest income of \$303.00.

Mr. Haber filed a New York State Resident Income Tax Return for the year 1986. On this return, he listed his address as 1438 3rd Avenue, New York, New York 10028. Mr. Haber reported wages of \$91,800.00 and interest income of \$1,347.00. The amount of wages reported on the return was equal to the total of the three wage and tax statements from Criticare which were attached to the return.

Petitioners, Leonard and Marina Haber, filed a joint New York State Resident Income Tax Return for the year 1987. The return stated that their address was 1438 3rd Avenue, New York, New York 10028 and reported wage income of \$95,350.00. The amount of wage income reported on the return is the same as the total of the wages reported on the series of wage and tax statements which were attached to the return.

The Division of Taxation ("Division") received information from an anonymous source that the corporate funds of Criticare were being employed for the personal use of Criticare's sole shareholder and president, Mr. Leonard Haber. As a result, the Division decided to conduct an

audit of Criticare and Mr. Haber.

In the course of its audit, the Division made repeated requests for the books and records of Criticare and Mr. Haber. The record shows the following:

(a) The Division mailed a letter, dated March 15, 1988, to Mr. Haber which, among other things, requested: (1) copies of Mr. Haber's Federal Form 1040 for 1985 and 1986 including all schedules; (2) all savings accounts passbooks from December 1, 1984 through January 31, 1987; (3) all "personal checking accounts, bank statements and checks" from December 1, 1984 through January 31, 1987, inclusive; (4) all brokerage statements from December 1, 1984 through January 31, 1987, inclusive; and (5) all "buy" and "sell" slips to substantiate all selling prices of sales of stock during the audit period.

In addition to the foregoing, Mr. Haber was asked to provide a power of attorney if a representative would appear on his behalf and the results of any Federal audit.

(b) In a letter dated December 1, 1988, the Division requested that petitioners' representative provide the following items: (1) description of the business activities of Criticare; (2) all State and Federal tax returns filed by Criticare; (3) cost of living information for Mr. and Mrs. Haber; and (4) a net worth listing of all assets and liabilities on January 1, 1985 and December 31, 1986.

(c) In a letter dated April 4, 1989, the Division advised petitioners' representative that the Division would need at least the Federal and State tax returns for one year within three weeks. Petitioners' representative was also informed that if the Division did not receive this information, assessments might be issued against the corporation and its officers solely on the basis of external indices.

(d) In a letter dated July 3, 1989, the Division advised Mr. Haber as follows:

"Dear Mr. Haber

"After repeated attempts to examine the books and records of Criticare Support Services Inc., and repeated assurances by Mr. Newman that I would be allowed to examine these books and records, no records have been made available to this date.

"An appointment has been set for July 6th, at Mr. Newman's office.

Mr. Newman has been advised to have present at this meeting all books and records including tax returns for at least one year.

"If this appointment is cancelled or records are not made available, assessments will be issued against Criticare as per letter dated 4/25/89 for \$208,057.12 in tax plus penalty and interest. Assessments would also be issued against you and any other responsible corporate officer and shareholder.

"A Power of Attorney has been enclosed. Without a completed Power of Attorney, I cannot fully discuss the case with Mr. Newman."

(e) The Division mailed the following letter, dated July 26, 1992, to Mr. Haber:

"Dear Mr. Habor [sic]:

"The following Audit reports reflect your tax liability based on the limited information made available. If within the next 10 days you wish to submit a full set of books and records for 1982-1988, I will examine them and make any adjustment which may be necessary.

"A complete set of books and records for 1982-1988 include:

- 1) General ledger
- 2) Payroll journal, cash receipts journal, cash disbursements journal, purchase journal and general journal.
- 3) Bank statement plus cancelled checks
- 4) Sales invoices
- 5) Bills for purchases
- 6) Year end trial balances and workpapers
- 7) Any Corporate tax returns filed

"Since your book [sic] and records were previously requested, no further extension will be permitted. A blank power of attorney has been enclosed."

(f) In a letter dated August 9, 1989, petitioners were asked to bring the items described in the letter dated March 15, 1988 and December 1, 1988 to an appointment at the Division's offices on August 22, 1989 at 9:30 A.M.

In response to the request for Mr. Haber's personal records, the only information received was transcriptions of a savings account and a checking account at Citibank. With respect to the request for corporate records, the Division was initially provided with only unfiled copies of the Federal Criticare returns for the years ending January 31, 1983 and

January 31, 1984.

At one juncture during the audit, the auditor was shown a printout of Criticare's disbursements and was told that checks were available if he wanted to "spot check" that the printouts were of monies paid to nurses. After being shown records, the auditor did not specifically ask for copies of the computer runs. None of the records presented to the auditor were in auditable form.

The Division compared the information provided by Mr. Haber with the information on Mr. Haber's New York State income tax returns. For the year 1985, the Division found approximately \$138.00 in interest income from the statements provided by Mr. Haber, whereas interest income reported on Mr. Haber's Resident Income Tax Return for 1985 was \$303.00. For the year 1986, the Division determined that interest income disclosed on the statements provided by Mr. Haber was approximately \$455.00, while the interest income on Mr. Haber's 1986 Resident Income Tax Return was \$1,347.00. On the basis of these discrepancies, the Division concluded that petitioner had an interest-bearing instrument that was not revealed. Further, the Division determined that the information provided was not sufficient to perform a cash availability audit.

In order to calculate the amount of tax due, the Division accepted the gross receipts on the corporate returns which were provided. However, the Division disallowed one-half of the cost of goods sold and other deductions, including net operating loss and depreciation, resulting in a revised taxable income for the corporation. The Division determined that the change in the revised taxable income from the year ended January 31, 1984 to the year ended January 31, 1985 was 54.5 percent. It then estimated the corporation's taxable income for the years ended January 31, 1985 through January 31, 1988 by adding annual increments of 54.5 percent to the adjusted taxable income for the year ended January 31, 1985. Since the Division concluded that it did not have enough information to perform a cash availability audit, the Division considered the additional corporate income to be unreported income to Mr. Haber.

In making the foregoing calculations, the Division disallowed one-half of Criticare's

salary expense for the amounts paid to Mr. Haber even though in later years the wage and tax statements matched the amounts reported by Mr. Haber as salary. At the hearing, the auditor acknowledged that this adjustment was improper.

On the basis of the foregoing audit, the Division issued a Notice of Deficiency bearing assessment number L-001404714-2, dated January 18, 1990, to Mr. Haber which asserted a deficiency of personal income tax for the years 1985 and 1986 in the amount of \$703,151.28, plus interest of \$185,082.77 and penalty of \$195,660.73, for a balance due of \$1,083,894.78. The Division also issued a Notice of Deficiency bearing assessment number L-001404715-1, dated January 18, 1990, which asserted a deficiency of personal income tax for the year 1987 from Leonard Haber and Marina Haber in the amount of \$585,346.18, plus interest of \$88,704.67 and penalty of \$283,781.20, for a balance due of \$957,832.05.<sup>1</sup>

In a letter dated April 17, 1990, petitioners' representative advised the Tax Compliance Division that his clients never received the Notice of Deficiency or the Payment Document with respect to assessment number L-001404715-1. Petitioners' representative noted that his clients only became aware of the Notice of Deficiency because of collection activity. The letter explained that a request for a conciliation conference was being made by letter because of time constraints.

Petitioners' representative attached to the foregoing letter numerous documents and correspondence. One document was a Payment Document bearing assessment number L-001404714-C001-9. This document listed Mr. Haber's corrected address as 145 East 81st Street, New York, New York 10028. A Domestic Return Receipt shows that the letter was received by the Tax Compliance Bureau on January 31, 1990.

The letter of April 17, 1990 also included a document entitled "Notification of Your Right to Protest an Action Taken by the New York State Department of Taxation and Finance."

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<sup>1</sup>A copy of the notice issued to Leonard Haber and Marina Haber was not included in the record. However, the Division offered a microfiche copy of said notice.

On this form, Mr. Haber requested a conciliation conference and listed his address as 145 East 81st Street, New York, New York 10028. A notation adjacent to the address stated that this was a new address. A Postal Service Domestic Return Receipt shows that the form was received by the Division on January 29, 1990.

As part of its records, Criticare maintained a list on a computer of its payments to nurses. When a nurse confirmed that she was available to work on a particular shift and a hospital verified that it wanted to employ someone for the same shift, a notation would be made in the computer records. The checks would then be drafted so that when the nurse appeared for work the check would be presented to the nurse.

There were times when the nurse did not appear for work and the check would be returned. At some point in time, the check would be voided on the general ledger but not on the payroll system. As a result, the total amount of the checks issued to the nurses shown by the computer payroll records was greater than the amount recorded on the books of the company. Petitioners' representative did not know the amount by which the computer payroll record overstated the amount of wages.

At the hearing, petitioners' representative offered a computer-generated list of payments made to nurses for the months of October 1987 through December 1987. According to this exhibit, the wage expense incurred by Criticare for nurses was as follows:

<u>Month</u>	<u>Net Pay</u>	<u>FICA</u>	<u>FWT</u>	<u>SWT</u>	<u>CWT</u>	<u>Gross Pay</u>
October 1987	\$ 297,682.92	\$ 4,632.88	\$ 5,890.28	\$1,968.71	\$ 914.19	\$ 311,088.98
November 1987	437,735.18	3,769.93	7,254.37	3,409.60	1,457.34	453,626.42
December 1987	<u>524,034.34</u>	<u>4,115.75</u>	<u>7,842.62</u>	<u>3,664.92</u>	<u>1,541.51</u>	<u>541,199.14</u>
	\$1,259,452.44	\$12,518.56	\$20,987.27	\$9,043.23	\$3,913.04	\$1,305,914.54

Petitioners offered a series of notices which were issued by the Internal Revenue Service to Critical Care Support Service formerly known as Crite-Care Support Service, Inc. Among other things, the notices set forth a particular tax period and a balance due as follows:

<u>Tax Period Ended</u>	<u>Balance Due</u>
March 31, 1987	\$267,573.83
June 30, 1987	267,573.83
September 30, 1987	267,573.83

December 31, 1987	267,340.00
December 31, 1987	116,625.70
March 31, 1988	692,131.37
September 30, 1988	686,815.74
December 31, 1988	667,963.15
December 31, 1988	213,804.43

Petitioners presented a document from the Internal Revenue Service entitled Examination Changes - Federal Unemployment Tax which stated that, for the calendar year 1987, Criticare had corrected total taxable wages of \$2,018,938.00. The same type of document for the year 1988 stated that the corporation had corrected total taxable wages of \$3,609,899.37.

At the hearing, petitioners' representative testified that, in 1989, the Internal Revenue Service made a claim that the monies paid to the nurses should have been paid as wages to an employee rather than a payment to an independent contractor. The issue was litigated in Bankruptcy Court which resulted in the decision that the relationship was that of a common law employee rather than an independent contractor. According to petitioners' representative, the amount of wages involved is shown on the documents that they offered from the Internal Revenue Service.

Petitioners' representative, Peter Newman, who also provided services as their accountant, reported to petitioner Leonard Haber. Mr. Newman's services included reviewing statements that were prepared by Criticare's internal employees. He also assisted the bookkeeper when questions arose as to how checks should be classified, and prepared internal financial statements from the internally generated documents.

Mr. Newman prepared returns for Criticare for certain years. At the hearing, Mr. Newman was uncertain which years they were. Mr. Newman also prepared personal income tax returns for petitioners; however, he could not recall the years for which the returns were prepared.<sup>2</sup>

One of Mr. Newman's duties was to prepare gross profit reports. The information used

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<sup>2</sup>The New York State resident income tax returns of Leonard Haber for 1985 and 1986 and Leonard and Marina Haber for 1987 list Mr. Newman as the preparer of the returns.



to prepare the reports was provided by the bookkeeper. Mr. Newman never assisted in original data entry or maintained the books or records of Criticare. He never drafted checks to pay expenses.

In response to the assertion of petitioners' representative that the Notice of Deficiency issued to Leonard Haber and Marina Haber was not properly mailed, the Division offered affidavits by Donna Biondo, Martin Dolan and Daniel LaFar. The affidavit of Donna Biondo states that she is the Head Clerk of the Carts Control Unit of the New York State Department of Taxation and Finance. The acronym "CARTS" stands for Case and Resource

Tracking System and refers to the system for generating notices of deficiency to taxpayers.

Ms. Biondo avers that she supervises the mailing of notices of deficiency and notices of determination. Ms. Biondo receives a computer printout, referred to as a certified mail record, and the corresponding notices of deficiency and notices of determination are generated by CARTS. Ms. Biondo continues that the computer-generated notices are predated with the anticipated date of mailing and each notice is assigned a "certified control number". The certified control numbers are recorded on the certified mail record under the heading "Certified No.".

Ms. Biondo states that she has examined the document attached to her affidavit as Exhibit "A" and that it is a true and accurate copy of the certified mail record for the block of notices of deficiency and the notices of determination issued by the Division on January 18, 1990. Ms. Biondo maintains that the original document consisted of 19 fan-folded (connected) pages and that all pages were connected when the document was delivered to the United States Postal Service. The pages remain connected when the postmarked document is returned to Ms. Biondo's office after mailing.

Ms. Biondo notes that, in the upper left hand corner of the first and last pages of the certified mail record, the date 1/9/90 was deleted and replaced by a hand-stamped date of January 18, 1990. It is then explained that the original date of January 9, 1990, which appears

on pages 2 through 18 of the certified mail record, was the date that the certified mail record was printed and that the practice is to print the certified mail record approximately 10 days in advance of the anticipated date of mailing of the particular notices so that there is sufficient time for the notices to be reviewed and processed by the Division's Mechanical Section.

Ms. Biondo asserts that the change of the date was made by personnel in the Division's mailroom who changed the date so that it conformed to the actual date that the notices and the certified mail record were delivered into the possession of the U.S. Postal Service.

According to Ms. Biondo, the U.S. Postal Service authorizes the use of certified control numbers in numerically consecutive blocks. This certified mail record uses one block of certified control numbers: certified control numbers P 001 061 040 through P 001 061 244 assigned to the items of mail listed on the 19 pages which comprise this certified mail record.

According to Ms. Biondo's affidavit, each statutory notice is placed in an envelope by Division personnel and the envelopes are then delivered to the possession of a U.S. Postal Service representative, who affixes his or her signature and/or a U.S. Postal Service postmark to a page or pages of the certified mail record. Ms. Biondo submits that the U.S. Postal Service representative signed and placed a postmark on the last page of the 19-page fan-folded certified mail record.

A U.S. Postal Service postmark dated January 18, 1990 and the signature of a Postal Service employee appear on the last page of the certified mail record. The names of the taxpayers on the certified mail record who are not involved in this case have been redacted to preserve confidentiality.

Ms. Biondo states that page 4 of the certified mail record indicates that a Notice of Deficiency with certified control number P 001 061 074 was sent to Leonard Haber, 1438 3rd Ave., New York, NY 10028. According to Ms. Biondo, the U.S. Postal Service postmark on the last page of the certified mail record confirms that the notice bearing assessment number L001404715 was sent to Leonard Haber on January 18, 1990.

Ms. Biondo submits that, in the regular course of business and as a common office

practice, the Division does not "request, demand or retain" receipts from certified or registered mail. Further, the procedures described in her affidavit were the regular procedures of the CARTS Control Unit on January 18, 1990.

The affidavit concludes with the observation that a microfiche copy of the Notice of Deficiency is attached bearing assessment number L001404715 and certified control number P 001 061 074. This is the same certified control number that appears next to the entry of Leonard Haber on the certified mail record.

The Division also offered a certified mail record. On its face, the information on the certified mail record corresponds with the description set forth in the affidavit of Ms. Biondo. Among other things, the certified mail record shows the following:

(a) The first sheet is labeled "New York State Department of Taxation and Finance - Assessments Receivable - Certified Record for Non-Presort Mail." In the upper right hand corner of the page, the pages are numbered from 1 through 19. The upper left hand corner of pages 2 through 18 of the certified mail record contains the printed date of "1/9/90". On the first and last page, this date was covered up and a new date of January 18, 1990 was stamped. Each page contains columns labeled "Certified No.", "Notice Number", "Name of Addressee, Street and P.O. Address", "Postage", "Fee" and "RR Fee". Certified numbers are listed in a vertical column on the left side of each page. A circular stamp of "Jan 18, 1990" appears on the last page. Some of the letters on the stamp are not decipherable. The name "P. Guynup" is handwritten near the stamp.

(b) Page 4 of the mail record contains an entry which sets forth petitioner's name and address (1438 3rd Avenue, New York, N.Y. 10028), a notice number (L001404715) and a certified control number (P 001 061 074). The last page of the certified mail record states that 205 pieces of mail were listed. The total number of pieces of certified mail recorded on the last page of the certified mail record corresponds with the total number of certified numbers. It also corresponds with the total postal charge recorded on the form in the amount of \$92.25 at a stated fee of \$0.45 per piece of mail.

The Division submitted an affidavit from a Daniel LaFar which states that he has been a Principal Mail and Supply Clerk since 1978. After establishing his familiarity with the subject matter, Mr. LaFar states that after a notice is placed in the outgoing certified mail basket in the mailroom, a member of the staff weighs and seals each envelope, affixes postage and fee amounts on the envelopes and records the postage and fee amounts on the certified mail record.

According to Mr. LaFar, a mailroom clerk counts the envelopes and verifies the names and certified mail numbers against the information contained on the mail record. Thereafter, a member of the mailroom staff delivers the stamped envelopes to the Roessleville Branch of the U.S. Postal Service in Albany, New York. The postal employee affixes a postmark and/or signature to the certified mail record indicating receipt by the U.S. Postal Service. On the basis of the foregoing, Mr. LaFar maintains that the certified mail record is the Division's record of receipt by the Roessleville Branch of the U.S. Postal Service for pieces of certified mail.

Mr. LaFar explains that, in the ordinary course of business and pursuant to the practices and procedures of the mailroom, the certified mail record is picked up at the post office the following day and delivered to the originating office by a member of the mailroom staff.

Mr. LaFar asserts that he has read the affidavit of Donna Biondo as well as the certified mail record and the microfiche copy of the Notice of Deficiency and can determine that on January 18, 1990 an employee of the mailroom delivered a piece of certified mail addressed to Leonard Haber, 1438 3rd Avenue, New York, New York 10028 to the Roessleville Branch of the United States Postal Service in Albany, New York in a sealed postpaid envelope for delivery by certified mail. Mr. LaFar further asserts that, based on a review of the certified mail record, he can determine that a member of his staff obtained a copy of the certified mail record with the postmark, delivered to and accepted by the post office on January 18, 1990, for the records of the CARTS Control Unit. Mr. LaFar also states that the procedures described in his affidavit regarding the mailing of a piece of certified mail are the regular procedures followed by the mailroom staff in the ordinary course of business when handling items to be sent by certified mail. Mr. LaFar concludes with the assertion that regular procedures in the ordinary course of

business were followed on January 18, 1990 in mailing the piece of certified mail described.

The Division also offered an affidavit from a Martin Dolan which explained that the affiant is a Senior Computer Programmer Analyst in the Information Systems Management Bureau. Mr. Dolan explained that as part of his regular duties he oversees the daily computer operations of the computer system which stores information and generates printed documents, including notices of deficiency and notices of determination ("statutory notices") which are sent to taxpayers. Mr. Dolan then avers that he made his affidavit on the basis of his own personal knowledge.

Mr. Dolan states that he has examined the microfiche copy of the Notice of Deficiency which is attached to his affidavit and that it is a true and accurate copy of the Notice of Deficiency issued on January 18, 1990 to Leonard and Marina Haber at 1438 3rd Avenue, New York, New York 10028. It is then explained that it is the Division's regular business practice to retain microfiche copies of statutory notices for the purpose of reducing paper usage and the amount of personnel resources devoted to the filing of hard copies of statutory notices.

Mr. Dolan then proceeds to explain the manner in which microfiche copies of statutory notices are generated and retained as follows:

"The Organization of Assessment Data

During the course of every business day, the Department's keyboard operators enter assessment data into the Department's CARTS (Case and Resource Tracking System) computer system from computer terminals. From the computer terminal, they direct the computer system to add a new 'case' using the information that has been entered. The 'on line' program which controls the data entry procedure then stores the data entered in a record format in the control area of the computer system until the close of business. After business hours each night, the 'Create Assessment' program within the computer system 'sweeps' the data in the computer's control area which has accumulated during the course of the day.

"This nightly sweep procedure takes the data in the computer, organizes it by assessment and, for each assessment, by filing period, assigns assessment numbers to the data for all the respective taxpayers and sets up a CARTS case in the computer system for each assessment for each taxpayer. For example, in this matter, the data for the Petitioners was organized and set up under assessment number L-001404715. Once a case has been set up in the CARTS system in this manner, Department personnel can access the case information from a computer terminal by keying in the assessment number.

"The Generation of Statutory Notices

After the case has been set up in the CARTS system, the creation of statutory

notices is controlled by the billing program within the system. This program updates interest and penalties and stores a record of the statutory notices and other documents which are generated by the CARTS system and sent to the taxpayer and/or the representative (e.g., Statement of Proposed Audit Changes, Notice of Deficiency, Notice and Demand, etc.). This record includes a description of the document generated and sent, the date on the document, the amounts due which were set forth in the document, the address on the document, and any other addresses to which the document was to be sent.

"The billing program produces a document when told to do so via a command entered by a data entry person. Once the particular notice has been created within the computer system by the billing program, but prior to printing, the data is copied onto one large computer disk referred to as the billing output file, so that it can be run through the Department's pre-sort procedure.

#### "The Pre-sort Procedure

The purpose of the pre-sort procedure is to prepare the particular notice for mailing. The pre-sort procedure is run by a computer program which, among other things, organizes the data so that the notices are sorted according to whether they are to be sent by regular first class mail or certified mail (Notices of Deficiency and Notices of Determination). They are then sorted within each batch by zip code, which results in a discount to the Department on postage costs. The hard copies of the notices are later printed and stacked according to zip code to facilitate the insertion of the notices and any attached pages into envelopes by a sophisticated machine referred to as an intelligent inserter.

"During the pre-sort procedure bar codes are placed in the upper left hand corner of each page of the notice so that the intelligent inserter knows how many pages are included with each Notice so that all pages can be inserted together into one envelope. The pre-sort procedure also entails the assignment of a certified mail control number to the particular notice. This number will correspond with the number appearing on the mailing log and the certified mail documentation affixed to the envelope at the time of mailing. The pre-sort program then inserts a code in the data which will be printed in the right margin of the microfiche. This code . . . is inserted so that the microfiche copy of the Notice can be sorted according to the particular Tax Department organizational unit that generated the statutory notice.

"Once the pre-sort procedure is complete, a computer file containing the data which will be printed on each statutory notice, is recorded on computer tape (hereinafter 'the record tape'). During the production of the record tape, the pre-sort program omits the bar codes and job control language (print formatting commands) such that the information generated, when applied to microfiche, will not be in the same format as the printed hard copy.

"Although the format is different, the content is identical except that (1) the microfiche contains a numerical code . . . which, among other things, represents the day and time that the nightly sweep procedure begins, and (2) the hard copy contains a similar code . . . . After the record tape has been generated, the pre-sorted data is then sent to the print phase of the computer system so the hard copy can be printed and sent to the taxpayer.

"A record tape is then sent to the New York State Office of General Services (OGS) twice a week. The computer system at OGS reads the information from the

computer tape and the information is then applied to microfiche using a special machine located at OGS. OGS then sorts the microfiche using the organizational unit code in the right hand margin . . . and, within approximately two days, sends the prepared microfiche to the Department at Building 9, Second Floor, where it is retained."

Mr. Dolan's affidavit proceeds with a comparison of a microfiche copy of the notice with a Notice of Deficiency which was sent to another taxpayer. The assessment information on the latter notice was redacted to preserve confidentiality. Mr. Dolan then explained that the microfiche copy was marked up and numerically cross-referenced to the hard copy of the Notice of Deficiency to illustrate that the microfiche copy is an unformatted copy of the hard copy of the Notice of Deficiency.

Mr. Dolan next explains that attached to his affidavit is a form which, at the time the Notice of Deficiency for this case was generated, was the overlay which is the blank form that the hard copy was printed on. The Department's letterhead and logo, the headings "Date", "Assessment ID", "Total Amount Due", "Payment Due Date", "Taxpayer ID", the boxing notation and the language "Keep This Notice for Your Records" is preprinted on the first page of the form. The language "Keep This Notice for Your Records", and the headings "Date", "Assessment ID", and "Taxpayer ID" are preprinted on the second page of the form. Mr. Dolan submits that the fact that these notations are preprinted on the form explains why they do not appear on the microfiche copy. Mr. Dolan concludes with the observation that, with the exception of the computer codes mentioned above, the microfiche copy of the Notice of Deficiency contains all of the information printed on the hard copy.

At the hearing, Mr. Mark Plostock, who was one of Criticare's accountants, estimated that 70 to 75 percent of the monies which Criticare received from the hospitals was paid to nurses as salary. He also explained that in addition to salary, Criticare incurred expenses for items such as telephone, office personnel, rent, utilities, stationery, individuals who worked in a computer room, a supervisor of the computer personnel and a supervising nurse. It was Mr. Plostock's opinion that during the years 1983 through 1984 Criticare had a complete set of books and records. The records consisted of documents generated by computer.

At the hearing on July 16, 1993, petitioners' representative produced voluminous records which the Division had not previously had the opportunity to review. In response, the Division offered to examine the documents. Therefore, the matter was continued in order to provide the Division with an opportunity to review petitioners' documents.

At the hearing on September 14, 1993, petitioners' representative stated that approximately seven to ten days after the first hearing, Criticare's records were delivered to Mr. Plostock. Sometime between August 4, 1993 and August 16, 1993, Mr. Plostock was served with a subpoena in a grand jury investigation. In response, Mr. Plostock turned over all of the records of Criticare to the grand jury. As a result, the Division never had the opportunity to review the records which were produced at the first hearing.

The respective answers of the Division in the Matter of Leonard Haber and the Matter of Leonard and Marina Haber did not assert that this was a proper case to pierce the corporate veil of Criticare. The issue of piercing the corporate veil was not raised at the hearing.

#### SUMMARY OF THE PARTIES' POSITIONS

In his brief, petitioners' representative contends that the audit was erroneous on the basis of several asserted errors. Specifically, petitioners assert that: (1) the auditor ignored the documentation presented to him that the corporation's largest expense was payments to nurses and disallowed one-half of that; (2) the auditor disallowed one-half of the compensation paid to Mr. Haber even though the compensation was reported on his income tax returns; (3) the auditor ignored checks which were available to validate the computer printouts and claimed he could not audit the original computer printout; (4) the auditor never examined the checks which were available to test the accuracy of the computer printouts; and (5) the auditor never asked for copies of the computer runs showing payments to nurses even though they were offered to him.

It is submitted by petitioners that the foregoing shows that the auditor's judgment of what constitutes auditable records is highly suspect. Petitioners then call attention to the testimony of their witnesses and argue that the tax returns reflect the expenses incurred. It is also argued that the computer run of the nurses' wages contains a complete list of checks.



Petitioners submit that sufficient records were presented to the auditor but ignored. Further, it is contended that the auditor has an obligation to consider the evidence placed before him. Petitioners maintain that even if the records were not in the proper form, the expenses may still be allowed as a deduction citing Cohan v. Commr. (39 F2d 540, 544).

Petitioners' argument continues that the audit was arbitrary. Petitioners submit that the auditor did not know whether the taxpayer was on a cash or accrual basis, had no concept of the corporation's pricing structure and cost factors, made no attempt to analyze information supplied to him, made projections without any basis, and even though cancelled checks were available, disallowed 50 percent of all corporate expenses. It is noted that the auditor even disallowed depreciation and net operating loss carryovers in his dividend computation. Further, petitioners submit that the auditor ignored bank statements. Lastly, it is argued that there was no showing that any monies were paid to or for the benefit of the stockholders.

In response to the foregoing, the Division argues that petitioners have failed to demonstrate that the Division erred in treating the additional income of Criticare as the unreported income of petitioners. In this regard, the Division notes that Mr. Haber was the sole shareholder.

The Division next argues that in this case it is appropriate to pierce the corporate veil, ignore the corporate shell of Criticare and impose liability on Mr. Haber as the recipient of unreported income.

The Division next contends that the inability to reconcile the returns with the interest per the account information shows that petitioners had other sources of interest income which were not made available during the audit. Therefore, petitioners had additional assets or sources of income they did not disclose. On the basis of the foregoing, the Division submits that there was a rational basis for its assessments and they must be sustained.

The Division next argues that the affidavits of Donna Biondo and Martin Dolan demonstrate that it properly mailed the notice bearing assessment number L-001404715 to petitioners on January 18, 1990.

The Division contends that the failure of petitioners to appear at the hearing and testify, as well as their failure to produce any relevant records, undermines their position.

In a reply brief, petitioners argue that the Division should not be allowed to raise the piercing the corporate veil argument for the first time in its brief. Petitioners also contend that they presented evidence to show that the expenses claimed by Criticare were incurred and that they were ordinary, necessary and reasonable.

Petitioners further submit that where taxpayers have not produced records establishing the amount of the expenses incurred and paid, they have nevertheless convinced courts that the expenses have been incurred and paid, citing the Cohan rule (Cohan v. Commr., supra). Petitioners maintain that the Division's estimates were so erroneous as to be denied credibility.

#### CONCLUSIONS OF LAW

A. The first issue to be addressed is whether the Notice of Deficiency issued to Leonard and Marina Haber was properly mailed. In this case, the correspondence in the record discloses that petitioners received neither the Notice of Deficiency nor the Payment Document with reference to the notice issued to Leonard and Marina Haber.<sup>3</sup>

B. Tax Law § 681(a) provides, in part, as follows:

"If upon examination of a taxpayer's return . . . the [Division] determines that there is a deficiency of income tax, it may mail a notice of deficiency to the taxpayer . . . . A notice of deficiency shall be mailed by certified or registered mail to the taxpayer at his last known address in or out of this state."

C. In order to establish that the notice was properly mailed to petitioners' last known address by certified or registered mail, the Division must provide evidence of the general mailing procedure and show

that the procedure was followed when the notices in issue were mailed (Matter of Katz, Tax Appeals Tribunal, March 11, 1993). Here, the Division has established its general mailing

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<sup>3</sup>As a result of collection activity, petitioners became aware of the existence of the notice in time to meet the deadline for filing a timely petition.

procedure and shown that the procedure was followed in this case. The assessment number on the microfiche copy of the Notice of Deficiency corresponds with the assessment number next to Mr. Haber's name and address on the certified mail record that was postmarked on January 18, 1990.

D. Tax Law § 681(a) does not require that the taxpayer actually receive the notice. A notice which is sent by certified or registered mail to a taxpayer's last known address is valid regardless of whether it is actually received (see, Matter of Kenning v. State Tax Commn., 72 Misc 2d 929, 339 NYS2d 793, affd 43 AD2d 815, 350 NYS2d 1017, appeal dismissed 34 NYS2d 667, 355 NYS2d 1028; Matter of Malpica, Tax Appeals Tribunal, July 19, 1990). Thus, if the notice is properly mailed, the risk of nondelivery is on the taxpayer (Matter of Malpica, supra).

E. The address listed for petitioners on the certified mail record is the same as the address listed by petitioners on their tax return for the last year in issue. Further, there is nothing in the record to indicate that petitioners advised the Division that they had a new address until they requested a conciliation conference, which was after the notices in issue were mailed. Therefore, it is concluded that the notice was sent to petitioners' last known address.

F. It is recognized that the Division did not offer a copy of the Notice of Deficiency which was actually mailed. The absence of the notice has been remedied in this instance by an explanation of the reason for the failure to be able to produce a copy of the original notice and the production of a microfiche copy of the notice which contains the pertinent information which was on the original notice. The affidavits and microfiche copy of the notice establish that a valid Notice of Deficiency was issued.

G. The next question presented is whether the adjustments made during the audit of Criticare were proper.

The record shows that the Division made repeated requests for Criticare's books and records. In response, the only items the Division initially received were unfiled copies of corporate income tax returns for the fiscal years ending January 31, 1984 and January 31, 1985.

Later, some records were shown to the Division at the office of petitioners' representative. However, these records were not in auditable form.

H. Considering the dearth of auditable records presented, it was reasonable for the Division to conclude that the expenses of Criticare were unsubstantiated and should be disallowed (Matter of Eisner, Tax Appeals Tribunal, March 22, 1990). The failure to produce auditable records warranted the decision to disallow one-half of Criticare's expenses.

Petitioners have not offered any evidence which establishes that the audit results were erroneous. Contrary to petitioners' assertion, the computer printout of wages offered at the hearing is of little probative value. First, the records are only for a three-month period, whereas the audit period is three years. Next, it is merely a record of payments without any backup. In the absence of substantiation, the entries on the computer records do not carry any weight (see, Matter of Eisner, supra). It is also significant that, as acknowledged by Mr. Newman, the records are inaccurate. With respect to the records which were subsequently presented to the Division, petitioners have not refuted the Division's claim that they were not capable of being audited.

I. Contrary to petitioners' suggestion, the documents from the Internal Revenue Service do not support the reliability of the payroll records. For the year 1987, the Internal Revenue Service found taxable wages of \$2,018,938.00. In contrast, the payroll records show total gross pay for the months of October through December 1987 in the amount of \$1,305,914.54. Thus, Criticare's payroll records for a three-month period in 1987 amount to almost 65 percent of the taxable wages found by the Internal Revenue Service for the entire fiscal year. Without some showing of how the Internal Revenue Service arrived at its figure for taxable wages, the apparent discrepancy leads to the conclusion that such figure similarly lacks support.

J. Petitioners' specific objection to the disallowance of one-half of the net operating loss deductions and depreciation deductions lacks merit. Said deductions, which reduced Criticare's income, must be substantiated like other deductions.

K. In the course of its audit, the Division disallowed one-half of the wage expense

attributable to Mr. Haber's salary despite the fact that, during the years in issue, salary was reported on wage and tax statements and Mr. Haber's personal income tax returns. At the hearing, the auditor acknowledged that this adjustment was improper. Accordingly, the Division is directed to recalculate the asserted deficiency by allowing Criticare a deduction for the salary expenses which correspond to the wage income claimed by Mr. Haber on his personal income tax returns.

L. Having concluded that, with the exception of Mr. Haber's wage income, the Division properly disallowed one-half of Criticare's expenses as unsubstantiated, the question becomes whether the Division properly attributed the additional income to petitioners as a constructive dividend.

In its brief, the Division asserted as one theory for prevailing that this is a proper case to pierce the corporate veil and impose liability on petitioners for additional unreported income. In response, petitioners objected to the raising of this issue for the first time in its brief.

M. In determining whether a new issue may be raised for the first time, it is necessary to distinguish legal from factual issues. The Tax Appeals Tribunal has consistently permitted raising new legal issues after the record has been closed (see, Matter of Howard Enterprises, Tax Appeals Tribunal, August 4, 1994). However, it has precluded the introduction of new factual issues after the record is closed because it deprives the party which bears the burden of proof of the opportunity to submit evidence (id.).

N. In deciding whether to pierce the corporate veil, the focus is upon:

"whether 'the corporation is a "dummy" for its individual stockholders who are in reality carrying on the business in their personal capacities for purely personal rather than corporate ends.' (Walkovszky v. Carlton, 18 NY2d 414, 418, 276 NYS2d 585, 588, 223 NE2d 6, 8.)" (Port Chester Electrical Construction Corp. v. Atlas, 40 NY2d 652, 389 NYS2d 327, 331.)

In resolving the foregoing inquiry, the critical factor is whether the external indicia of a separate corporate entity were maintained (id.). Since the latter inquiry is factual in nature, petitioners are correct in asserting that the Division may not raise the piercing the corporate veil argument for the first time in its post-hearing brief.

O. In Matter of Petito (Tax Appeals Tribunal, October 17, 1991), the Tribunal affirmed the determination of the Administrative Law Judge which found that the petitioner received a constructive dividend. The reasoning of the determination, which was found by the Tribunal to be correct, stated that since the taxpayer was an officer and shareholder, in the absence of an explanation as to the disposition of the additional corporate income, he is deemed to have received the income in proportion to his interest in the corporation. The Petito case is instructive insofar as it shows that it is unnecessary to pierce the corporate veil in order to find a constructive dividend.

P. Similarly, in this case, Mr. Haber was the president and sole shareholder of Criticare. Since there has been no explanation of the disposition of the additional corporate income, the Division properly deemed the same to have been received by Mr. Haber.

Q. Petitioners' reliance upon the Cohan rule (Cohan v. Commr., supra) is misplaced. Under the Cohan rule, when a taxpayer establishes entitlement to some amount of a deduction, the court may permit some portion of the deduction claimed even though the taxpayer has not proved the exact amount of the deduction. However, when estimating the amount of the deduction, a court should attempt to achieve a close approximation "bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making" (Cohan v. Commr., supra).

R. In Matter of Schneier (Tax Appeals Tribunal, November 9, 1989), the Tribunal observed as follows:

"Current trends in case law indicate that courts in their interpretation of the Cohan rule no longer always require some amount of deduction, however small, to be given where the taxpayer has shown that he is entitled to some deduction and none has been granted (Lerch v. Commr., 877 F2d 624). Rather, in situations where the taxpayer has refused to provide evidence upon which an estimation could reasonably be based, courts have denied the deduction claimed altogether (Lerch v. Commr., supra; Pfluger v. Commr., 840 F2d 1379)."

S. In the present case, the production of voluminous records at the first hearing shows that petitioners had records which they could have provided to the Division. Inexplicably, petitioners provided virtually no access to these records. Subsequently, the records were subpoenaed by a grand jury. The inference to be drawn is that, at the time the audit was being

conducted, petitioners had records which they chose to conceal from the Division. Under these circumstances, petitioners may not rely upon the Cohan rule to justify a greater deduction than that already allowed by the Division.

T. It is noted that no error has been shown by the Division's failure to give any weight to Mr. Haber's transcript of interest income. The fact that during the same period of time greater income was reported on the personal income tax returns than on the transcripts of interest income establishes that Mr. Haber was not forthcoming with information regarding his assets.

U. The petitions of Leonard and Marina Haber are granted to the extent of Conclusion of Law "K" and the Division is directed to modify the notices of deficiency accordingly; except as so granted, the petitions are denied and the notices of deficiency, dated January 18, 1990 and April 30, 1990, are sustained together with such penalty and interest as may be lawfully due.

DATED: Troy, New York  
September 21, 1994

/s/ Arthur S. Bray  
ADMINISTRATIVE LAW JUDGE